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No. 93-332

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1993

MICHIGAN MUNICIPAL COOPERATIVE GROUP AND
THE STATE OF MICHIGAN,
*Petitioners,*
v.
FEDERAL ENERGY REGULATORY COMMISSION AND
MIDLAND COGENERATION VENTURE, L.P.,
*Respondents.*

On Petition for a Writ of Certiorari to the
United States Court of Appeals
for the District of Columbia Circuit

## REPLY BRIEF OF THE MICHIGAN MUNICIPAL COOPERATIVE GROUP AND THE STATE OF MICHIGAN

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## REPLY BRIEF OF THE MICHIGAN MUNICIPAL COOPERATIVE GROUP AND THE STATE OF MICHIGAN

The Michigan Municipal Cooperative Group (MMCG) and the State of Michigan submit this reply to the briefs in opposition filed by the Midland Cogeneration Venture (MCV Br.) and for the Federal Energy Regulatory Commission by the Solicitor General (FERC Br.).

### I. THIS CASE MERITS REVIEW BECAUSE OF ITS MULTI-BILLION DOLLAR RATE IMPACT AND ITS ADVERSE IMPACT ON MARKET COMPETITION

MMCG and the State of Michigan have shown that, despite a statute prohibiting utilities from owning "qualifying cogeneration facilities" (QFs) under the Public Utility Regulatory Policies Act (PURPA), 16 U.S.C. § 796(18)(B)(ii) (1988), FERC certified a utility-owned and controlled facility as "qualifying" for special rate benefits, thereby exempting its rates from normal rate

regulation. MCV (MCV Br. at 14) and FERC (FERC Br. at 6-7) attempt to treat this case as a run-of-the-mill regulatory decision. Until this case, FERC interpreted its regulations prohibiting utility ownership of QFs by requiring QFs to comply with two independent limitations: (1) a utility may not receive more than 50% of the benefits from a QF, and (2) a utility may not control a QF. (See Pet. at 7-8, 15-16) Here, FERC effectively drops the control test and ignores $1.2 billion in the utility's share of benefits (or, by FERC's own test, project ownership). The following table (distilled from Pet. at 5-6) shows the nature and magnitude of the problem:

| | |
|---|---|
| Normal cost of this type plant | $800 million |
| Total cost of MCV Plant | $ 2.3 billion |
| which includes: | |
| Amount of MCV payment to CPC for abandoned nuclear assets | $ 1.2 billion |

FERC and MCV do not answer how the utility's non-arm's-length arrangement with its affiliate, MCV, to be paid $1.2 billion for assets to be included in a plant, when the entire plant should have cost only $800 million, is anything other than a transfer of benefits to the utility. FERC has effectively announced a new rule violating, and gutting FERC's own long-standing interpretation of, PURPA's prohibition against utility ownership of QFs.

If this case merely raised issues of asset valuations, the Supreme Court might not deem it worthy of review (although the magnitude of the rate impact, combined with FERC's blatant disregard for statutory standards, might suggest otherwise). But, here, FERC has acted contrary to its own regulations and to PURPA. The effect will be to deregulate a substantial portion of electric rates, contrary to PURPA, the Federal Power Act and state law. The cost to electricity users and the economy will be billions of dollars.

MCV and FERC do not deny these adverse impacts, except by denying the premise that the utility owns MCV (MCV Br. at 18; FERC Br. at 10-11), which is addressed below. Perhaps even more significantly, and di-

rectly contrary to federal enactments and this Court's precedent, *see, e.g., Gulf States Utils. Co. v. FPC*, 411 U.S. 747 (1973), the result will be to reinforce electric utilities' monopoly control of generation, whereas the statute was intended to promote competing generation plants independent of utilities. As this case illustrates and Congress recognized, if utilities can own QFs, the incentives and opportunities for self-dealing are so great that utilities will find every way to prefer purchases from affiliated generators rather than independents.[1] Because FERC's decision controls regulation at the state level (see Pet. at 25), FERC's abandonment of its statutorily-imposed duties prevents adequate state regulation as well.

## II. MCV AND FERC FAIL TO ANSWER KEY ISSUES AS TO OWNERSHIP AND CONTROL

MCV and FERC do not address many of the troubling questions raised by FERC's orders. Without addressing the merits of Petitioners' arguments, MCV assumes that it is entitled to QF status and the benefits that flow from it. (MCV Br. at 16 n.8, 18) Neither MCV nor FERC fully confronts the language of the statute. PURPA clearly states that QFs may be owned only "by a person not primarily engaged in the generation or sale of electric power. . . ." 16 U.S.C. § 796(18)(B)(ii). Congress thus sought to encourage non-utilities to enter the cogeneration field. *FERC v. Mississippi*, 456 U.S. 742, 750-51 (1982); *Puerto Rico Elec. Power Auth. v. FERC*, 848 F.2d 243, 249 (D.C. Cir. 1988). This goal, along with PURPA's market-based incentives, *see American*

[1] Unfortunately, if such utility self-dealing is countenanced, this Court's observation will no longer hold true that "when utilities purchase electric energy from qualifying facilities at full avoided cost rather than at some lower rate, the rates the utilities charge their customers will not be increased, for by hypothesis the utilities would have incurred the same costs had they generated the energy themselves or purchased it from other sources." *American Paper Institute, Inc. v. American Elec. Power Serv. Corp.*, 461 U.S. 402, 415 n.9 (1983). The utility, as happened here, will distort the avoided cost rate determination by seeking higher, not lower, rates for QFs. See Section III, *infra*.

*Paper Institute, Inc. v. American Elec. Power Serv. Corp.*, 461 U.S. 402, 414-15 (1983), is defeated by improper utility involvement in QFs. Even if some minority utility ownership of QFs is accepted, the language and goals of PURPA require FERC to protect against utilities' manipulating their amount of ownership interest and, through contracts with affiliates, receiving the majority of benefits from purported QFs.

MCV and FERC do not address the heart of Petitioners' demonstration that FERC has violated both PURPA and even its own, more generous "stream of benefits" and control tests. As to the utility ownership prohibition, MCV (MCV Br. at 15) and FERC (FERC Br. at 7-8) continue to rely on the illogical conclusion in FERC's orders that MCV's unaffiliated investors' acceptance of the $1.2 billion asset price establishes that the payment was not a mechanism to transfer profits to the utility. The fallacy lies in FERC's erroneous assumption that the unaffiliated investors could control whether Consumers Power Company's (CPC) share of the total profits (or benefits) from the project exceeded 50%. They could not, and MCV and FERC do not assert otherwise. Thus, FERC establishes a sham test allowing utility ownership of QFs, directly contrary to statute.

The other owners' ability to police the price of the assets was limited by the contract between CPC and MCV (signed while CPC was still the admitted 90% owner of MCV), which only prohibited an asset price so high that the remaining profits would not suffice to meet the unaffiliated investors' prescribed minimum investment returns. (See Pet. at 17-19) The outside investors had no ability to limit the asset price to the true cost of obtaining equivalent assets independently. Because CPC controlled the project from the outset, the only way the outside investors could participate in the deal was on CPC's terms. Thus, the inflated component of the asset price, approximating $1.2 billion, constituted a transfer exclusively to CPC of potential MCV profits. Those transferred profits, when added to CPC's 49% share of all other MCV profits,

pushed CPC's ownership share well above even FERC's generous limit of 50%.[2]

In support of their claims that FERC adequately analyzed CPC's control over ~~MCV,~~ MCV and FERC rely (MCV Br. at 8; FERC Br. at 8) on FERC's assertion below that it is common for developers to enter into contracts prior to the operation of a cogeneration facility. Merely pointing this out does not address the fact that the contracts passed to CPC significant benefits and effective control over MCV for periods of up to 35 years. Moreover, CPC did not establish a QF and then sell its entire interest to non-utility owners. When still a 90% owner of the project, CPC set up contracts between itself and MCV to be paid $1.2 to $1.5 billion for the nuclear assets, to establish future prices for its purchase of the project's output, and to provide for future gas supply, financing, management and other aspects of the project. Although CPC later reduced its stated interest to 49% to *facially* comply with FERC's regulations, it maintained active involvement in all aspects of the project. In light of this, FERC was obligated to scrutinize the contracts among the owners. *See Allegheny Elec. Coop., Inc.*, 47 FERC ¶ 61,015 at pp. 61,053-55 (1989) (even where there is a technical divestiture, control may remain and bar QF certification). MCV (MCV Br. at 15) and FERC (FERC Br. at 8) also rely on FERC statements that the unaffiliated partners could exercise majority control and oversee the contracts. As pointed out in the Petition (at 21), FERC's explanation that the preexisting contracts did not establish control because the new 51% partners could breach them is preposterous, and neither opposing brief seeks to defend it. FERC's obligation to protect against improper utility ownership and control of QFs demands more.

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[2] Both MCV (MCV Br. at 6) and FERC (FERC Br. at 4) point out that CMS Midland did not participate in the negotiations over the price of the assets. However, another CPC affiliate, MEC Development Corporation (MDC) was involved as seller of the assets. (MCV Br. at 6) CMS Midland and MDC shared the same chairman with MCV. (JA-1282, JA-1479, JA-2067)

MCV's contentions that FERC was not obligated to hold a hearing and that it has broad discretion to formulate its own procedures (MCV Br. at 16-17) do not overcome FERC's obligation to follow its own substantive regulations. *Columbia Broadcasting Sys., Inc. v. United States*, 316 U.S. 407, 422 (1942); *United States v. Nixon*, 418 U.S. 683, 695-96 (1974) (citing *United States ex rel. Accardi v. Shaughnessy*, 347 U.S. 260, 266-68 (1954)). Even though a QF may self-certify, where FERC is asked to find that a facility is a QF, it must act consistently with statutory standards. If the Commission does not fairly consider relevant facts or issues, then its exercise of discretion should not be upheld. *Udall v. FPC*, 387 U.S. 428, 434 (1967); *Scenic Hudson Preservation Conference v. FPC*, 354 F.2d 608, 612-13 (2d Cir. 1965), *cert. denied*, 384 U.S. 941 (1966). Here, FERC permitted improper utility ownership of a QF, contrary to both PURPA and its own regulations. The decisions below are an invitation to other utilities to engage in similar activities, which will distort electricity markets, limit regulatory authority and, ultimately, increase electricity rates nationwide. (See Pet. at 25-30)

## III. FERC'S ACTIONS IMPAIR STATE REGULATION

MCV (MCV Br. at 2, 17, 18) and FERC (FERC Br. at 11-12) claim that MMCG and the State of Michigan's real complaint is not with FERC but with the avoided cost rate set by the MPSC. FERC's erroneous recertification of MCV is indeed the root of the problem, because it has distorted the regulatory process by which the State of Michigan sets its avoided cost rates. Unlike an independent purchasing utility, which has an incentive to keep the avoided cost rate low, CPC, as creator and owner of MCV, has huge economic inventives to avoid dealing with independent QFs, to negotiate *high* rates for MCV power, and to fight for a *high* avoided cost rate before the MPSC, all contrary to its interests as a utility and to the public's interest. It is FERC's action, not the MPSC's, that entitles MCV to the special PURPA rates and to exemption from state regulations that might normally be

expected to protect ratepayers from the injuries caused by utility self-dealing.

In asserting that the state can control the QF rate, MCV ignores limitations under state law[3] on the ability of regulatory commissions to control this rate, including limitations created by the exemptions received as a result of the very decisions MCV defends. The MPSC has itself recognized the evils inherent in the non-arm's-length MCV-CPC dealings and its inability to effectively control them. (See Pet. at 11-12, 28; see also JA-590) Perhaps recognizing these factors, Congress gave FERC the authority to certify QFs, and it is no excuse for FERC's failure to perform its statutory duty to say that the states may help partially alleviate the consequences of that failure.

State regulation and principles of federalism are also impeded when FERC refuses to give any weight, if not preclusive effect, to state administrative decisions. MCV (MCV Br. at 16) and FERC (FERC Br. at 9) maintain that the MPSC did not decide the identical issues of control for purposes of PURPA that were before FERC, and thus contend that FERC was not obliged to give preclusive effect to the MPSC's findings. However, the MPSC made specific findings regarding the identity of interests between MCV and CPC, the lack of arm's-length dealings, and the blurring of corporate identities. (See Pet. at 11-12)[4] These findings went to the control determination FERC had before it, yet FERC refused to give these findings any weight. This Court has found that factual findings relevant to issues properly before the fact-finding agency could have preclusive effect before a second

[3] The law will vary in each state. For example, in Michigan the avoided cost rate underlying a QF contract can be fixed for 17½ years, Mich. Comp. Laws § 460.6j(13)(b)(ii), and the MPSC's ability to limit managerial discretion over the utility's choice of suppliers has been construed to be limited. *Consumers Power Co. v. Pub. Serv. Comm'n*, 189 Mich. App. 151, 472 N.W.2d 77 (1991), *leave denied*, 439 Mich. 917, 479 N.W.2d 644 (1992).

[4] Describing CPC's renegotiation of an MCV contract, the MPSC stated the problem clearly: "one must wonder whether Consumers has once again negotiated with itself and lost." (JA-590-91)

agency, even where the first agency would not have had jurisdiction to decide the precise issue before the second agency. *United States v. Utah Constr. & Mining Co.*, 384 U.S. 394, 418-19 (1966). Thus, the findings made by the MPSC that bore upon FERC's control determinations should have been given preclusive effect. At minimum, they could not be ignored without FERC's either providing a rational explanation for doing so or making a factual investigation, especially where FERC's decisions, based upon *unexamined* factual assumptions (Pet. App. 32a, 148a-50a, 192a), could become the basis for preempting state authority.

MCV (MCV Br. at 16) and FERC (FERC Br. at 9) also attempt to distinguish *University of Tennessee v. Elliott*, 478 U.S. 788 (1986), on grounds that it did not concern the preclusive effect of a prior determination on a federal agency. Neither explains why the principles underlying collateral estoppel, *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 326 (1979), should be any less applicable when the forum is a federal agency instead of a federal court.[5] FERC also suggests that in PURPA, like in Title VII, Congress intended that state administrative agency determinations not be given preclusive effect. (FERC Br. at 9, citing *Elliott*, 478 U.S. at 795-96) However, unlike Title VII, PURPA contains nothing, and FERC points to nothing, that indicates congressional intent to prohibit FERC from considering the MPSC's findings.

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[5] While FERC claims that so long as its disagreement over an issue with a state administrative finding is supported by substantial evidence, the court of appeals should have to uphold it (FERC Br. at 10), the "substantiality of evidence must take into account whatever in the record fairly detracts from its weight." *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 488 (1951). Here, FERC refused to investigate evidence that contradicted its conclusions that CPC did not control MCV and ignored the findings of the MPSC, which had conducted extensive hearings. (See JA-1485-1919)

## IV. RESPONDENTS' CLAIMS OF PROCEDURAL DEFECTS ARE INSUBSTANTIAL

MCV's and FERC's claims (MCV Br. at 9, 13; FERC Br. at 8-9) concerning alleged "defects" in the record are unavailing. They incorrectly claim that MMCG and the State of Michigan have not raised FERC's exclusion of supplemental materials. The Petition does raise this issue. (Pet. at 21) FERC based its decision on the application presented and admittedly refused to look behind it. (Pet. App. 32a, 148a-50a) Thus, the "record" basis for the decision consists essentially of MCV's assertions. Materials in opposition were mainly petitions requesting agency investigation, which were refused.

FERC does not deny that it had discretion to accept the supplemental materials which MMCG and the State of Michigan presented as a motion to lodge or a motion to reopen the record. (Pet. App. 162a-68a); *see also Udall v. FPC*, 387 U.S. at 434; *Ohio Bell Tel. v. Pub. Utils. Comm'n*, 301 U.S. 292, 300-06 (1937). Nevertheless, FERC refused to accept them because it deemed them irrelevant on the basis that FERC could consider the MCV QF application to be correct without any investigation. (Pet. App. 32a, 148a-50a) Because the Petition assigns error to the Commission's refusal to accept the proffered materials (Pet. at 21-23), the issue is before this Court.[6]

As for MCV's claim (MCV Br. at 10-12) that Petitioners failed to preserve their challenge to FERC's regulation allowing utility participation, MMCG and the State of Michigan did raise the issue, arguing that the 50% level was too high and that, to the extent the regulation conflicted with the statute, the statute controlled. (JA-1248-49, JA-1251, JA-1254-55) MCV's claim, that Petitioners' challenge is barred because it was not raised at the time the rule was promulgated (MCV Br. at 12), ignores that where "an aggrieved party has a valid excuse

[6] In any event, other bases for granting the writ remain and are supported by materials timely filed by any measure (including MPSC findings). (See, e.g., JA-585-93)

for failing to challenge the initial order promulgating a regulation," it is permissible to challenge the regulation when it is applied. *Raton Gas Transmission Co. v. FERC*, 852 F.2d 612, 615 (D.C. Cir. 1988). MCV's approach would flood agencies with interventions every time a rule is promulgated, because all potentially interested parties would be required to protect against speculative harms the rule might cause, if applied to future (unknown) projects. Moreover, the Court can reverse the court of appeals' affirmance of FERC without reaching the issue, given the clear demonstration that MCV does not meet even FERC's generous 50% ownership test or its control test.[7]

## CONCLUSION

For the foregoing reasons and for the reasons stated in the Petition for Certiorari, the Court should grant the writ and reverse.

Respectfully submitted,

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[7] MCV's "renewed" contention that Petitioners lack standing is similarly without merit. (MCV Br. at 10 n.5) MMCG members and Michigan citizens purchase power from CPC at rates that (now or in the future) will include the costs of CPC's purchases of high cost power from MCV, which claims QF status. In addition, some MMCG members have excess capacity to sell and compete directly with MCV in the power supply market; MCV's QF certification assertedly permits CPC to purchase from MCV instead of from cheaper sources. *See* 16 U.S.C. § 824a-3(a) (1988). Petitioners' actual injuries are ongoing and result from MCV's claimed QF status.

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